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No. 160

SUPREME COURT

of the United States

REYNOLDS SPRING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

– and –

BRIEF IN SUPPORT THEREOF

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

TO THE HONORABLE, THE SUPREME COURT OF THE UNITED STATES:

Your Petitioner respectfully shows:

I.

SUMMARY STATEMENT OF THE MATTER INVOLVED

There is here presented a question of invested capital for the purposes of excess profits taxes of the years 1940 and 1941. The case was submitted upon a Stipulation of Facts (R. 35-9) and the Returns (R. 34) not printed. There is no difference of view as to the facts or any inference therefrom.

Petitioner in 1931 declared and distributed as a dividend in kind in partial liquidation shares of capital stock (being all the outstanding shares) of General Leather Company which Petitioner had acquired in 1924, by issuing shares of its own capital stock therefor. The question is whether by reason of such dividend in kind there should be deducted from equity invested capital the amount which was added thereto when said shares were acquired or the fair value of said shares at the time of such dividend in kind. There is no mention of a dividend in kind in the statute, which provides what shall be added and what shall be deducted in arriving at invested capital. The Commissioner deducted the amount which was added to invested capital at the time of the acquisition. The Tax Court upheld and the Court of Appeals affirmed. In no other situation which has been conceived is there ever a deduction of the amount added at the time of acquisition. At the time of acquisition the fair value of the shares was $2,412,875.83 (R. 36). And at the time (7 years later—the second year of the depression) of distribution in dividend in kind the fair value was $742,830.00 (R. 38). Petitioner had a substantial deficit which had arisen from operations, $698,760.84 at the beginning of the year 1931, in which the shares were distributed in dividend in kind (R. 38), and had no taxable income in said year. The distribution was charged on the books in such manner as to increase the deficit by $2,412,875.83 (R. 38). But the amount of a deficit still continues as "invested capital."

II.

STATEMENT DISCLOSING BASIS OF THIS COURT'S JURISDICTION

The Decree of the United States Court of Appeals for the Sixth Circuit, a review of which is here sought, was

entered April 19, 1950 (R. 47). The statutory provision relied upon to sustain the jurisdiction of this Court is Section 1254 of Title 28 of the United States Code, as amended to January 1, 1950.

III.

QUESTION PRESENTED

There is only one question involved in this petition:

> Where a corporation acquires property (shares of capital stock of another corporation) by the original issue of its own capital stock and after holding such property for seven (7) years makes a distribution (not out of accumulated earnings and profits) in kind of such property to its (the acquiring Corporation's) stockholders, is the equity invested capital (under Section 718 of the Internal Revenue Code) of such corporation reduced thereby by the value of the property (shares so distributed) at the time of distribution, or at the time of acquisition?

IV.

REASONS RELIED ON FOR ALLOWANCE OF WRIT

1. The Court of Appeals has decided a Federal question, namely, what is meant by "invested capital" as used in the excess profits tax law in a way which conflicts with the applicable decision of this Court in *LaBelle Iron Works vs. U. S.*, 256 U. S. 377. In the cited case this Court said that by invested capital was meant money or money's worth laid out or embarked in the enterprise. In the instant case the Court of Appeals talks about "inflated computa-

tions" (R. 51, l. 37), and "actual capital investment" (R. 53, l. 9), and "the same basis should be used in determining loss" (R. 53, l. 4), clearly treating it as something to be determined as of some later date as affected by changes in the interim and not confined to the time the particular item of capital was embarked in the enterprise.

2. The Court of Appeals has decided an important question of Federal law which has not been but should be settled by this Court, namely the effect on invested capital (for excess profits tax purposes) of dealing with assets in a manner not specifically mentioned in the statute as by a dividend in kind. Should there be a different effect in this one case from that in all cases specifically mentioned in the statute and all other cases which have been conceived? This is apparently a case of first instance in the Courts. No case seems to have heretofore been presented involving any question of "deduction" in arriving at invested capital.

3. The effect on the distributing Corporation of a dividend in kind was held by the Tenth Circuit (*General Securities Company vs. Commissioner,* 123 Fed. (2d) 192) to be "the value of assets distributed" *at the time of distribution,* whereas the Sixth Circuit has held in the instant case the effect to be value *at the time of acquisition.* True, the holdings were for different purposes—the Tenth Circuit for dividends paid credit, and the Sixth for equity invested capital. But the same matter—Dividend in Kind—cannot have one effect for one purpose and another effect for another purpose. Especially where the statute—Section 728*—specifically states "the terms used" in the one chapter "shall have the same meaning" as in the other chapter.

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*Set forth in full, infra 17.

4. The Court of Appeals has so far departed from the accepted and usual course of judicial proceedings as to find "a gap in the law" (no specific mention in the statute of dividend in kind) and then to fill that gap in such a way as to make the gap an exception from all other cases instead of filling the gap to conform to all other cases. Petitioner maintains there is no gap, but if there is a Court should either fill it to conform or leave it alone. Petitioner maintains there is no gap because the statute provides what deductions shall be made in arriving at invested capital from which it must follow that what is not so provided to be deducted is not to be deducted.

V.

PRAYER FOR WRIT

Wherefore, your Petitioner respectfully prays that a Writ of Certiorari issue out of and under the seal of this Honorable Court, directed to the United States Court of Appeals for the Sixth Circuit, commanding that Court to certify and send to this Court for its review and determination a full and complete transcript of the record and all proceedings of that Court had in this case, which is numbered and entitled on its docket 10,945, REYNOLDS SPRING COMPANY, a Delaware Corporation, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent, to the end that this cause may be reviewed and determined by this Court; that the judgment of that Court be reversed, and for such further relief as to this Court may seem proper.

THOMAS G. LONG,
Counsel for Petitioner.

No.....

Supreme Court of the United States

REYNOLDS SPRING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I.

OPINIONS BELOW

The Opinion of the Tax Court (R. 20), was rendered January 31, 1949, and is reported in 12 T. C. No. 16 (paged volume not yet received). The Opinion of the United States Court of Appeals for the Sixth Circuit (R. 48), was handed down April 19, 1950, and has not been reported at the time of the printing hereof.

II.

STATEMENT OF THE CASE

The statement appearing at pages 1 and 2 in the Petition for Writ of Certiorari is deemed adequate and is hereby adopted and made a part of this Brief.

III.

SPECIFICATION OF ERRORS

Petitioner intends to urge and rely upon each of the following errors assigned to the Judgment of the United States Court of Appeals for the Sixth Circuit:

1. In not holding that "invested capital" as used in the excess profits tax law means money or money's worth laid out or embarked in the enterprise and is unaffected by any subsequent change in the value of the property in which invested.

2. In not holding that "invested capital" is subject to reduction only by the deductions provided in Section 718(b).

3. In not according to "distributions" as used in Section 718 (b) (1) the same meaning as in Section 115 (c), namely—value at time of distribution.

4. In holding that invested capital of a corporation making a distribution in kind can be affected in a different amount in respect of the property distributed than the stockholder who receives the distribution.

5. In holding that the increase in the deficit of Petitioner by the distribution in kind reduced the invested capital.

IV.

ARGUMENT

There is but one ultimate question presented by this case, namely—that stated in the Petition for Certiorari, supra 3.

This case concerns the application of Section 718 of the Internal Revenue Code. The section is set forth in all necessary part, infra 16. This case concerns solely the acquisition of the capital stock of another corporation by the issue by Petitioner Corporation of shares of its capital stock and the distribution (7 years later in the second year of the depression), of the capital stock so acquired as a dividend in kind to the then shareholders of Petitioner in *partial liquidation.* This distribution was nine (9) years before the tax year here in question.

The pertinent provisions of Section 718, therefore, are:

Equity invested capital

> "*shall be the sum of the following amounts.*
>
> • • •
>
> (2) Property • • • previously paid in • • • for stock • • •. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange
>
> "*reduced as provided in subsection* (*b*)
>
> (b) The amount by which equity invested capital • • • shall be reduced • • • as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in Previous Years*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

Then follow several other provisions, none of which are applicable or have any relevancy to the determination of the question here presented.

Invested capital (for excess profits tax purposes) does not mean the value (market, book or otherwise) of the assets employed in the business during the period in question. But rather as indicated in *LaBelle Iron Works vs. U. S.*, 256 U. S. 377.

Money or Money's Worth *Laid Out* by the Investors In *Embarking* Their Means In the Enterprise*

The propositions following are generally regarded as not open to question:

If property acquired by a corporation—

is retained by the corporation any lessening in value below cost is of no effect on invested capital;

is sold by the corporation at less than cost the loss does not affect *invested* capital but *earned* surplus only;

is wholly lost by total destruction (as physical property by fire or tornado, or corporate stock by bankruptcy of the corporation), the effect is but the same as in case of a sale.

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*Not a literal quotation but see: Page 388, lines 5 and 6;
Page 390, lines 6 and 7.

Impaired Capital Is Still Invested Capital

If the distribution here in question had been a *taxable dividend the* shareholders receiving it would have been taxed *at the value at the time of distribution.*

Internal Revenue Code, Sec. 27 (d);

Regulations 111, Sec. 29.115-10.

Petitioner's dividend paid credit would also have been the value at the time of distribution.

Internal Revenue Code, Sec. 29.27(d);

Regulations 111, Sec. 29.27(d)-1.

While this was not a dividend taxable in the year of distribution, nevertheless it went to reduce the shareholders' base and hence would affect future taxes in event of sale by the shareholders or complete liquidation by the corporation. A holder of shares of Petitioner in 1931 who acquired his stock in 1924 at market would have a cost base of $53.80* per share. If the distribution in 1931 is to be charged against his base at the value of General Leather stock *at the time of acquisition* the reduction would be $16.25 per share, whereas if reduced by the value *at the time of distribution* the reduction would be $5.00 per share. Thus the shareholder in the event of sale of his stock or liquidation of the corporation is to be taxed on $11.25 per share on which he would not be taxed if the dividend had

*The figures in this paragraph are approximate in round figures. They are readily calculable from the figures in the record as printed and Exhibit A not printed. As the figures are used merely as illustrative it is deemed not necessary to set out the calculations in detail nor make reference to the pages of the Record.

been a presently taxable dividend. In fact, he is to be taxed on $11.25 as profit which is in very fact the loss he has sustained in the General Leather Stock transaction. This is legerdemain in effect.

It is obvious that the proper *corporate accounting* of the distribution in partial liquidation would be to deduct the value at the time of distribution $742,830.00 from capital and charge the difference, $1,670,045.83, between that value and value at the time of acquisition to surplus. But where as here the Company already had a deficit of $698,760.84, the effect of any proper charges was necessarily to increase the overall deficit by the amount which had been entered on the books at the time of acquisition. But as before stated, increase in deficit does not affect invested capital.

The opinion of the Court of Appeals talks about a construction "essential to guard against inflated computations" (R. 51, l. 7), and to avoid a computation "which does not accurately reflect actual capital investment" (R. 53, l. 9), but *equity invested capital* is not supposed to represent the capital still continuing to be held in the enterprise. It does not under any of the conditions stated supra 9, as to which there can be no question. Equity invested capital is as indicated in the *LaBelle Iron Works* case, supra 9—that which was *embarked* in the enterprise. It makes no difference what has become of it. "Actual capital investment" in the tax year involved has nothing to do with the question.

The Court of Appeals further said, "In the distribution the corporation returned to the stockholders the identical property which had been previously invested" (R. 51, l. 2).

That is to say, that the stockholders now hold directly the same shares that they formerly held collectively through the corporation and therefore nothing had been affected. But this is not correct, for the corporation is for tax purposes an entity in itself. And as pointed out, supra 10, the stockholder's tax base for the future has been affected so that a portion of the remaining value of his shares in Petitioner Corporation will, in the event of a sale or liquidation, be taxed as profit whereas that portion is in fact a loss.

The decision of the Tenth Circuit referred to in point 3 of the Petition for Certiorari, supra 4 (*General Securities Company vs. Commissioner,* 123 Fed. (2d) 192), dealt (just as does the instant case) with a dividend in kind in shares of the capital stock of a second corporation which had been acquired by the Petitioner Corporation by the issue of shares of its own capital stock. The shares of the second corporation had in each case decreased in value between the time of acquisition and the time of distribution. The Tenth Circuit in that case held the "adjusted basis" could not be used saying the "actual assets, surplus and earnings were only reduced to the extent of the value of the asset distributed" (page 194, column 2, lines 28 to 30). The Sixth Circuit in the instant case held the "adjusted basis" for gain or loss must be used in determining the effect of the dividend in kind on invested capital. Section 728 (set forth in full, infra 17), expressly provides "the terms used" for the one purpose "shall have the same meaning" for the other purpose. The term here in question used in each chapter is "distribution"—singular or plural. It is in Section 115(a) of the Internal Revenue Code before the Tenth Circuit in the *General Securities*

case, and Section 718(b) (1) before the Sixth Circuit in the instant case. As it is required to be given the same meaning in each case it cannot have opposite results.

The Court of Appeals (R. 52) and Tax Court as well (R. 26), cite and quote from the case of *R. D. Merrill vs. Commissioner,* 4 T. C. 935. There the Company had an earned surplus and the Tax Court ruled that the excess in cost of dividend in kind over market value should be charged against earned surplus. Obviously, as the Tax Court there said, if this were not done the Company would be *carrying an asset on its books* which the Company no longer had. In the instant case, Petitioner had no earned surplus and therefore had to enter the amount as a surplus deficit. But in either case this is but ordinary and obviously required *corporate accounting.* It has nothing to do with the question with which we are concerned in determining equity invested capital, namely—what money or money's worth was *embarked* in (at any time made a part of the capital of) the enterprise. Corporate accounting has to do with what money or money's worth is in the enterprise at the current date—not the date of the inception. No question of invested capital was involved in the Merrill case.

The word "distribution" used in Section 718 (b) (1) had a well-defined meaning in the income tax law before and at the time the word was put into the excess profits tax law on the enactment of the latter on October 8, 1940. The word had long been used in Section 115 of the Internal Revenue Code and earlier Acts. In Section 115 (c) it is provided—"amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." This is the provision under which the tax base of the stockholders receiving the "distribu-

tion" here in question is to be determined. Section 115 (c) further provides that the "gain or loss" to the distributee resulting from [a distribution in liquidation, partial or complete] shall be determined under Section 111. In turn, Section 111 (b) provides "the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." Thus it is beyond question that so far as concerns the stockholder the distribution which has been made to him is the fair market value at the time of such distribution. Section 728 provides, "the terms used in this chapter [relating to excess profits tax] shall have the same meaning as when used in Chapter 1," i. e., the chapter relating to income tax.

If anything further is needed beyond the plain words of the statute the following *liquidation cases* all hold that the factor which affects the taxpayer's base is the fair market value of that which was received in liquidation at the time so received.

Boudreau vs. Commissioner, 134 Fed. (2d) 360 (5);

Sherman vs. Commissioner, 146 Fed. (2d) 219 (6);

Fleming vs. Commissioner, 153 Fed. (2d) 361 (5).

It cannot be that the "distribution" in the statute means one thing as applied to the distributee stockholder and another thing as applied to the distributing corporation. Especially where the statute expressly says the words shall have the same meaning in each chapter.

It is respectfully submitted that a question is here involved of a nature which this Court should pass upon and that error has been committed by the Court of Appeals and the Writ of Certiorari should be granted.

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APPENDIX

INTERNAL REVENUE CODE:

SEC. 718 [As added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in Section 113 (b) (2);

(3) *Distributions in Stock.*—Distributions in stock—

• • •

(4) [As amended by Section 203, Revenue Act of 1941, c. 412, 55 Stat. 687.] *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable years;

• • •

(b) *Reduction in Equity-Invested Capital.* — The amount by which the equity-invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in Previous Years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

(2) *Distributions During the Year.* — Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

• • •

SECTION 728. The terms used in this subchapter shall have the same meaning as when used in Chapter I.